Submission by Jeff Humphreys to
MySuper Working Group

<u>STRONGER SUPER PROPOSALS</u>

Issues Paper on Insurance
March 2011

I am an actuary who has been providing advice on the design and pricing of life and disability benefits provided by superannuation funds since 1986. The advice over the last decade has been predominantly to Industry Funds and Master Trusts and has also included advice to the insurers operating in this market. I have included my resume as Attachment 1.

I understand that MySuper is being designed solely with the interests of members in mind. My comments are made in this spirit and do not necessarily reflect advice I have provided to the industry in the past.

As a point of principle, it is appropriate to include insurance for life and disability as part of the MySuper product as the ability to maintain adequate pre retirement income is critical for most members (and arguably more important than adequacy of post retirement income):

a) Pre-retirement income is a key determinant of post-retirement income. Members with interrupted salary patterns have significantly lower superannuation account balances when they retire than those who have uninterrupted salary patterns.

b) Pre-retirement income is often required to support financial dependants such as children. This is rarely the case with post-retirement income.

Having said this there are several areas where the MySuper product can be improved and this is the focus of my comments. My suggestions for change are set out in boxes after each heading. This is followed by the reasons for the suggestion.

In my submission I have used "IP" as an abbreviation for "Income Protection".

1. Opt-Out Insurance - Life Insurance Cover

Life insurance cover provided by MySuper should not include Government regulated minima as set out in current Regulations. The Government should be asked to revisit its decision in this regard.

Alternatively, if minimum levels of insurance are to be mandated, they should be meaningful and be based on members' interests as current levels are inappropriate.

The reasons for this are:

a) The current minimum levels are inappropriate at younger ages as very few if any members die with financial dependents. (Looking after financial dependants is the only reason for life insurance in superannuation).

   The latest available ABS data (33020DO007_2009 Deaths, Australia, 2009) shows that in 2009, of the 2,840 deaths of persons aged under 25, **none were married**.

   More detailed work could be undertaken to perhaps include Defacto relationships but the conclusion will remain. Compulsory opt out default life cover for members under age 25 is not in members' interests and is a waste of, at these ages, their limited contributions.

   Younger members will be forced to pay unnecessary premiums unless the Regulations are modified or removed.

b) At older ages, the minima are so low that they add no value to members as the vast majority if not all funds provide default life insurance well above these levels;

c) The current minimum levels are set with a fixed cost in mind regardless of the member's age. This is not in the interests of members as the resulting cover levels do not reflect the changing needs of members as they age; and

d) The current minimum levels are set as dollar amounts and these quickly become out of date and when set through Regulation are hard to vary.

If minimum levels are to be specified more work is required to determine what these levels should be so that they meet the interests of members and do not simply reflect the current design of some superannuation funds.

I note also that if trustees have an obligation to offer insurance in the best interests of members and must develop and publish their Insurance Strategy, this should be sufficient requirement and safeguard. Minima set by Regulation or a regulator are not required.

For similar reasons to those outlined above, the minimum life cover premium in the Regulations should be repealed.

2. Opt-Out Insurance - Disability Cover Insurance

Question 1.3

Trustees should be required to offer Opt-Out disability insurance (TPD or IP) to members. Trustees should be allowed to offer both TPD and IP insurance.

The current proposal is that trustees must offer TPD as a default disability benefit, while offering IP insurance would be optional.

The requirement to provide TPD in MySuper sends the wrong message to Trustees and members as it suggests that TPD is a preferable or better benefit than IP. In fact TPD insurance is by far the weaker of the two disability benefits when considered from the member's point of view and the only reason to include it in the default and exclude IP from the default is that this mirrors what some funds currently do. This is not a criterion on which MySuper is to be based as I understand it.

Premium spent on IP insurance provides far greater value to members than premium spent on TPD insurance as the IP benefit is more focused on the members' needs and this is discussed in more detail below.

The current proposal should be replaced with the requirement that trustees offer a default disability benefit, being either TPD or IP, but not specifying one in particular. Trustees would be able to offer both TPD and IP as part of their default insurance benefit.

The reason this change is suggested is that the IP benefit is a superior benefit to the TPD benefit:

a) While a disabled member may not receive the IP benefit or a reduced IP benefit for various reasons, the member is far more likely to receive an IP benefit than a TPD benefit.

b) The IP benefit is related directly to the member's loss (being their earnings from personal exertion) and therefore the premium is better targeted than the TPD benefit;

c) The IP benefit provides an income stream benefit while the TPD benefit provides a lump sum and with this the disabled member must manage major risks including longevity, inflation, investment and exploitation risks;

d) The IP benefit can include a component to replace superannuation contributions and this is a very important benefit given the adequacy of retirement savings is such a key objective of superannuation;

e) The IP benefit has a rehabilitation and return to work philosophy as its basis. This is clearly in the interests of members. Contrast this with the TPD benefit which provides no design features at all in this regard and in fact encourages members to stay out of the workforce for long periods in order to obtain their benefit; and

f) The TPD benefit takes far too long to be paid given the financial stress most disabled members find themselves in. The Issues Paper raises this issue in its reference to the advantages of IP insurance. "[IP insurance] will usually provide benefits to members in the long period that it can take to be assessed for TPD benefits". Most disabled members require income within a few months of becoming disabled as their sick leave runs out. TPD benefits only very rarely provide this and in fact have an average delay to payment from date of disability well in excess of 12 months.

Issues Paper - Reasoning

The reasoning used to justify the final disability insurance design should be revisited.

The Issues Paper sets out reasoning for the exclusion of IP insurance as a compulsory Opt-out benefit to be provided by Trustees and sets out reasons for allowing trustees to include it if they wish as an Opt-Out insurance benefit. There is very little discussion in the Issues Paper on why TPD should be compulsory. The reasoning in the Issues Paper is deficient. A full discussion of the deficiencies is included in Attachment 2.

However, as an example, IP insurance is not compulsory because "income protection insurance has characteristics that may mean it is of minimal value to certain members". Sick leave and lack of employment are the only two characteristics sited. Attachment 2 discusses these further. The point here is that:

- TPD insurance also "has characteristics that may mean it is of minimal value to certain members." For example members who are partially disabled or temporarily disabled will not receive a TPD benefit. The Issues Paper does not address this or explain why TPD has favoured status. It ignores the fact that far more disabled members will receive a benefit from their IP insurance than from their TPD insurance, and in a more timely and useful manner.

- Similarly life insurance has characteristics that may mean it is of minimal value to certain members eg for those who don't have financial dependents. Again these make up a far greater percentage of members than those affected by the IP issues listed in the Issues Paper. Of the three benefits, life TPD and IP, the IP benefit is the most focused on the member's needs and the most likely to provide a benefit of value to the member.

There is a risk that this type of defective reasoning will become accepted by trustees and members as the basis for their insurance design and this will be to the detriment of members generally

Question 2.1

It is not in members' interests for MySuper to specify definitions and this proposal should be removed. Alternatively the definitions proposed should reflect current market best practice.

The definitions suggested are not appropriate because:

a) The requirement for IP benefits that "Benefits must not continue to be provided while the member is working in any capacity, or is eligible for TPD benefits" is inappropriate and detrimental to members. This requirement would reduce the rehabilitation benefits provided by IP insurance, benefits which include partial disability benefits that allow members to transition back into the workforce.

   Cessation of IP benefits on TPD is also inappropriate and poor benefit design, not least because the value of future IP benefits is in many cases far greater than the value of the TPD benefit and it is clearly detrimental to penalise disabled members in this regard. There is also a moral hazard for members as an insurer may pay a TPD benefit in order to reduce their overall liability.

   There is no reason why the two benefits should not sit side by side. Very few funds nowadays cease IP benefits on TPD.

b) The Issues Paper states that "It is intended that the (IP) definition means that benefits must simply assist the member to rehabilitate and return to work." it is unclear why the Issues Paper intends this. These are certainly advantages of the IP insurance benefit. However, the primary reason for having IP insurance is the replacement of some or all of the member's income lost through disablement in a form that the disabled member can manage (income stream). The legislation reflects this.

c) The Issues Paper states that "Income protection insurance must only provide benefits as a non commutable income stream for a period not exceeding the period of incapacity from employment of the kind engaged in immediately before the temporary incapacity". This is inappropriate because:

- Members with a permanent incapacity, not just those with a temporary incapacity should clearly be entitled to the IP benefit. Many of these members will also not meet the TPD definition and therefore under the proposal as it stands would be denied any disability benefit.

- The restriction to the member's "employment of the kind engaged in immediately before the temporary incapacity" means that a member cannot attempt a return to work through an alternative occupation that may suit them now or through rehabilitation or retraining. The requirement provides a financial incentive not to retrain or rehabilitate and this is very poor design both from the disabled member's point of view and because it will lead to higher claims costs and therefore premiums.

d) The definitions for IP create major transition issues as the proposed definitions are so poor compared with those currently applying in the market, particularly for industry funds and master trusts. Trustees will be forced to remove significant benefits from members in order to offer a MySuper product to existing members. This similarly applies to TPD though perhaps the suggested definitions are not as far removed from market definitions in this case.

e) While they may or may not be appropriate today, without a very rapid and flexible process for change, specifying definitions risks the MySuper product becoming obsolete or inappropriate for members over time and it no longer being in their interest. This could be because the definitions fall behind those available under alternative products or that the definitions for some reason become too generous and cause a blow out in premiums. It is very difficult to see how a process could be incorporated into MySuper that would ensure currency of definitions and therefore, specifying definitions is not in members interests.

The definitions suggested are restrictive and will make the MySuper product vulnerable to a loss of members for what may be second order reasons.

Definitions are a detail that is better left up to the market to sort out, backed up by the obligation on trustees to offer insurance in the best interests of members and to have in place an Insurance Strategy.

Question 3.1

Trustees should be able to offer optional additional insurance in their MySuper Product

A default benefit cannot suit all members and it is to be expected that a proportion of members will require additional cover and some of these will want to act on this requirement.

There should be no restriction on trustees offering members additional insurance cover (life, TI, TPD, IP). Any restriction would force members requiring more cover out of MySuper and this may not be in their interest.

The obligation to offer insurance in the best interests of members and to formulate an insurance strategy provides members with sufficient protection against excess and abuse.

Yours faithfully,

Jeff Humphreys

Attachment 2

Issues Paper – Analysis of the Reasons Used to Justify the Disability Design of MySuper

a) TPD Insurance

The only reason given for making TPD insurance compulsory for trustees is that it "establishes a safety net for members and their dependents to help meet the costs associated with total and permanent disablement of the member". There is no discussion on how this acts as a safety net. It is unclear how providing the severely disabled member with a large lump sum to manage after a considerable delay is a safety net. Page 4 and 5 of the submission set out reasons why TPD insurance is not the best safety net.

b) IP Insurance - not appropriate as a compulsory offering

Trustees will not be required to offer IP insurance. The reason given for this is that it may not be suited to all members of a fund. In various parts of the Issues Paper examples are given of why this is the case:

(i) A member may have sufficient work based leave arrangements;

(ii) A member may not be employed;

(iii) It can also be expensive, and the cost of premiums detracts from retirement savings.

Considering each of these in turn:

(i) The Australian workforce changes employers at high rates and this works to keep accrued sick leave down. Accrued sick leave for most Australians will very rarely be sufficient to cover even a short period of disablement. The IP waiting period is designed to broadly take this into account and the premium reflects the fact that sick leave may be an offset for some members;

(ii) Current designs allow for periods on unemployment;

(iii) This is an inappropriate reason as it equally applies to TPD and life insurance.

The Working Group has also identified offsets associated with IP insurance. These could include where members are covered by Workcover, or hold similar insurance cover outside or inside superannuation.

In relation to the Workcover offsets, TPD cover in Victoria is also offset as I understand it, if the benefit is taken. This does not appear to be recognised in the Issues Paper. To the extent IP insurance is inappropriate for these members so too is TPD cover.
In relation to other insurance cover, it is clearly the member's responsibility to ensure that they are not over insured and this is hardly a reason to deny all other members access to a better benefit design.

Importantly, IP insurance is an indemnity product, meaning that it replaces a part or all of the loss of the member. If this loss is met from another source or there is no loss (eg people who have decided to exit the workforce and therefore have no earnings from personal exertion) then no benefit is payable. This is a very advantageous part of the design as it reduces the premium accordingly.

The Issues Paper sets out the benefits of IP insurance. Unfortunately, the benefits listed for having IP insurance are minor benefits and the primary benefits have been omitted. By omitting many of the benefits of IP insurance, the decision to not require IP insurance as an Opt Out default insurance is questionable.

The benefits set out in the Issues Paper are:

a) It can assist members to be able to continue contributing to superannuation by helping meet the costs of finding new employment;

b) It replaces income for a temporary absence from the workforce; and

c) It will usually provide benefits to members in the long period that it can take to be assessed for TPD benefits

There are issues with each of these reasons.

a) This is a very indirect benefit of Income Protection insurance only. The benefit will be applied by the member to meet ongoing expenditure commitments, one of which may be finding new employment. In addition, in many cases the disabled member will not need to find new employment but will return to their job or another job with the same employer.

b) It is incorrect to suggest this benefit is paid only for temporary absence. IP insurance also replaces income for a permanent absence from the workforce and does not distinguish between the two states of disability The distinction between temporary and permanent is not even a realistic concept for many disabilities at the time a person becomes disabled as the final result of a disability is unknown until the member returns to work or reaches retirement ages or dies.

c) This presumably is a reference to the long delay between disablement and payment of the TPD benefit being on average well in excess of 12 months IP insurance is much more than a band aid for the TPD insurance benefit.

The primary benefits for including IP insurance have been missed by the Issues Paper. These have been set out on page 4 and 5 of the submission and are not repeated here.